Summary of Testimony of
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Chairman, Federal Energy Regulatory Commission
Before the Committee on Energy and Natural Resources
United States Senate
July 26, 2001

The guiding principle for restructuring legislation should be to provide a foundation for the development of a robust wholesale competition in the electric industry. This would provide electric customers with supply sufficient to meet their energy needs at the lowest reasonable cost. The Commission remains committed to developing market-oriented policies that promote the addition of necessary transmission and generation, and that allow for the detection and remedying of any anti-competitive behavior.

Legislation should help ensure that transmission owners and operators have economic incentives to operate and expand the transmission grid to meet the needs of all consumers and other market participants. Order No. 2000 encourages the formation of regional transmission organizations (RTOs). The industry has responded positively, with innovative efforts to develop efficient and nondiscriminatory RTOs, because they make economic sense, not because of a legal mandate.

We need to rely on competition instead of traditional regulation wherever possible. Existing laws that hinder competition, such as PUHCA and PURPA, need to be modified or repealed.

The Commission has no direct statutory authority to promulgate and enforce a set of mandatory reliability standards. Possible approaches to reliability include enforcing standards through identified performance-based measures or through voluntary contracts. Congress should understand, however, that mandatory reliability rules alone are not enough to ensure the reliability of the grid.

I believe the Commission does not need any additional statutory authority under the the Federal Power Act to remedy the problems experienced in California and the West. It is important to recognize the primary source of the problems: demand kept growing, but supply did not. The long-term solution to these problems is to have the balancing of supply and demand done by the marketplace, not the government.

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I. Overview

Mr. Chairman and Members of the Committee:

Good morning. Thank you for the opportunity to speak today on legislative proposals relating to restructuring of the electric utility industry.

Our fundamental electric utility laws were enacted during the Great Depression. These laws made sense in their time, when competition in the industry was more a theory than a reality. These laws were meant to provide a regulatory substitute for competition. Today, however, these laws often have the ironic effect of preventing the development of competition, harming the very consumers they were supposed to protect.

I believe the guiding principle for restructuring legislation should be to provide a foundation for the development of a robust wholesale competition in the industry, thereby providing electric customers with supply sufficient to meet their energy needs at the lowest reasonable cost. This principle requires different approaches in the transmission and generation parts of the industry.

Transmission will have to remain regulated for the foreseeable future. However, transmission must become a stand-alone business and respond to the market. Legislation should help ensure that transmission owners and operators have economic incentives to

design, build, operate, and expand the transmission grid to meet the needs of all consumers and other market participants.

In contrast, in the wholesale power sector, we need to rely on competition instead of traditional regulation wherever possible. Existing laws that hinder competition need to be modified or repealed. While the Commission stands ready to intervene in power markets when market rules or other factors lead to unjust and unreasonable prices, legislation reducing the existing barriers to entry will minimize the need for such efforts in the future.

II. Transmission Jurisdiction

In 1996, the Commission adopted Order No. 888, requiring all public utilities to offer nondiscriminatory, open access transmission service over facilities they own, control or operate. This service has been a major factor in the growth of wholesale competition in the past few years. Most wholesale buyers and sellers now have many more trading options than they had in the past.

In late 1999, the Commission adopted Order No. 2000, encouraging the formation of regional transmission organizations (RTOs). The industry generally responded positively, with innovative efforts to develop large, efficient and nondiscriminatory RTOs. The Commission, too, has worked hard to give the industry timely and constructive guidance on the development of RTOs. If properly constituted and truly independent, RTOs can help address and eliminate remaining obstacles to competition and make the markets more efficient, for the benefit of electricity consumers in all states. Indeed, RTOs support wholesale competition and, where states choose to pursue it, retail competition.

But even in the absence of retail competition, consumers will benefit from increased competition in wholesale markets. For example, RTOs can be structured to eliminate "pancaking" of transmission rates, better manage transmission congestion, and facilitate transmission planning across a multi-state region. There is still a lot of work to do, but I remain confident that we will reach our RTO goals.

I see no need for enactment of legislation allowing FERC to mandate the formation of RTOs. The industry is already forming RTOs because they make economic sense, not because of a legal mandate. If RTOs did not make economic sense, then nothing would be gained by requiring their formation. I am particularly pleased to see that transmission owners, with the urging of (rather than a directive from) the Commission, increasingly are reaching the conclusion that a particular type of RTO – a stand-alone, truly independent transmission company – will best serve the interests of consumers and the market as a whole.

Some argue that the Commission's jurisdiction should be expanded to include all transmission by non-public utilities. However, proposed RTOs in various parts of the country are making efforts to include the facilities of non-public utilities. If the industry succeeds in including the facilities of non-public utilities in RTOs, there may be no need for legislation broadening Commission jurisdiction over non-public utilities. The priority for Congress now should be to reduce or remove any legislative barriers to RTO participation by non-public utilities.

I also do not see a need for legislation requiring FERC to adopt uniform rules on interconnections. The development and implementation of broad RTOs will, in turn, promote the development of standardized and non-discriminatory interconnection procedures. A truly independent RTO has every incentive to maximize throughput and no incentive to hinder the interconnection of new generation.

III. Reliability

The recent changes in the electric power industry have increased the incentive for, and frequency of, violations of reliability rules adopted by the North American Electric Reliability Council (NERC). Unfortunately, NERC lacks authority to enforce its rules. As a result, the issue confronting the industry is whether federal action on reliability is necessary.

The Commission has no direct statutory authority to promulgate and enforce a set of mandatory reliability standards. While reliability issues sometimes fall within the Commission's ratemaking jurisdiction, the Commission in those cases does not decide whether the reliability of service is acceptable per se. Rather the Commission decides whether the rates, terms and conditions of service are just, reasonable and not unduly discriminatory or preferential from a commercial perspective.

The lack of federal authority to address reliability issues, and increasing concern about the shortcomings of the traditional voluntary approach to reliability issues, have led some in the industry to seek other approaches. One approach to enhance reliability and promoting customer accountability is to give energy providers an incentive to provide

reliable, efficient service. Conventional pricing methods do not provide adequate incentives. It is my preference to afford utilities some type of performance-based measure of accountability to their customers and their regulators. Consistent with its existing authority, the Commission could tie earnings and profits to reliability-based and performance-based criteria.

Another approach that has been pursued is enforcing reliability standards through contracts. Public utilities may voluntarily include reliability-related provisions in contracts or tariffs filed with the Commission because they affect or relate to the rates, terms and conditions of jurisdictional service. If reliability provisions in Commission-jurisdictional contracts are accepted and on file with the Commission, the Commission can enforce the reliability-related provisions against public utility parties to the contracts.

A system of such contractual arrangements has been established by utilities in the Western Systems Coordinating Council (WSCC), the regional reliability council for the Western United States. The effectiveness of the WSCC arrangement and the Commission's ability to enforce it have not been fully tested. But, a voluntary contractual regime is not the simplest or most effective means of establishing and adequately enforcing reliability standards. It depends solely on the willingness of public utilities to make voluntary filings and, even then, it may not capture the electric facilities of non-public utilities. Reliability is at risk to the extent that not all market participants are covered by the same requirements.

Another approach to ensuring reliability is enacting federal legislation. This year, on May 17, the Administration released its National Energy Policy Report. The Report recommends that the President direct the Secretary of Energy to work with the Commission to improve the reliability of the interstate transmission system and to develop legislation providing for enforcement by a self-regulatory organization subject to the Commission's oversight.

I believe a legislative approach may be preferable to the contractual approach discussed above. I take no position, however, on whether the legislation should be based on the proposal supported by NERC or any other version of reliability legislation.

Congress should understand, however, that mandatory reliability rules alone are not enough to ensure the reliability of the grid. In its Order No. 2000 on RTOs, the Commission set out at length the need for an RTO to ensure reliability in each region. In particular, RTOs must have the authority to ensure the short-term reliability of the regional grid and must be responsible for planning, and for directing or arranging, necessary transmission expansion and upgrades that will enable it to provide efficient and reliable transmission service.

As discussed below, we also need to find ways to encourage and facilitate the construction of new transmission facilities. And, of course, we must have adequate generating resources. The Commission is continually reassessing its existing regulations and policies to promote market entry and the removal of regulatory barriers to enhanced competition in the wholesale supply and interstate delivery of energy products and

services. For example, on March 14, 2001 and May 16, 2001, the Commission issued orders removing regulatory obstacles and providing incentives to increased energy supply and reduced demand in California and the rest of the West.

IV. Power Sales Rates and Market Power

While not the focal point of today's hearing, the problems recently in the electricity markets in California and the Western United States are an inescapable background to some of the legislative proposals now being considered. Those problems have led many to argue that the Commission needs additional statutory authority or obligations to ensure that wholesale prices remain just and reasonable.

I disagree. Since I became Chairman in January of this year, the Commission has used its existing authority firmly and effectively to mitigate prices in Western markets. The Commission has issued dozens of orders this year involving wholesale markets in California and the West. As a result of those orders and other factors, prices in those markets are continuing to decline substantially.

The problems in California were not caused by any inadequacies in the Federal Power Act regarding rates and market power, and preventing such problems in the future is not dependent on adding to the Commission's authority or obligations. Instead, such arguments merely distract us from the primary source of the problems: demand kept growing, but supply did not.

The long-term solution to these problems is to have the balancing of supply and demand done by the marketplace, not the government. While the Commission has

acknowledged and addressed the need for short-term, market-oriented price mitigation in California and the West, these measures must not become permanent crutches. We must find market-driven ways to promote new sources of supply and transmission, and encourage appropriate conservation by consumers. Price mitigation should continue no longer than absolutely necessary, and should be replaced as soon as possible by full reliance on market-based outcomes.

V. Regional Transmission Planning and Siting

Since the Commission adopted its open access requirements in 1996, the use of the interstate transmission grid has grown dramatically. Also, wholesale markets have become much more regional than local, encompassing large multi-state areas. Unfortunately, however, the grid has not been expanded commensurately. Thus, the grid increasingly is pushed to its operational limits, and transmission constraints frequently prevent the most efficient use of generation facilities. The institutional structures for planning and expanding the grid are not meeting our needs.

In planning grid expansions, we need to move toward a more regional approach. I believe RTOs can fulfill this role. By definition, RTOs will encompass large trading areas. An RTO-based planning process will allow all market participants within these areas to express their needs and concerns. Since RTOs must be independent of market participants, all participants will be assured of a nondiscriminatory planning process. RTOs that are based on the model of a stand-alone, for-profit transmission company will be particularly

motivated to expand the grid when appropriate to maximize transmission throughput, and thus, transmission revenue.

The authorization and siting of grid expansions has generally been performed under state law. While some argue that state authorities are too parochial to perform this responsibility well in today's regional, multi-state markets, I am not so persuaded. However, a federal backstop role may be appropriate in certain circumstances. For example, Congress could reasonably decide to establish a federal siting process, subject to certain limitations, if an RTO is unable to obtain siting authorization from a State within a specified time.

VI. Market Transparency Rules

In the past, utilities had little or no reason to keep their costs and transactions confidential. Utility prices were fully regulated on a cost-plus model, and competition was generally insubstantial. In today's competitive markets, however, confidentiality of price and customer information can be critical to a utility's success.

The Commission has seen increasing struggles among industry participants on how to reconcile the need for confidential information in competitive markets with a statutory and regulatory framework premised on full disclosure of cost and price information. It is not yet clear to me how best to reconcile these tensions. One approach the Commission has used is to require disclosure of bids in centralized trading markets, but only after a lag of several months. Other approaches may be feasible, too, so long as they reasonably balance the needs of competitors to preserve commercially-sensitive information with the

needs of regulators and the public for information to ensure that jurisdictional rates remain just, reasonable and not unduly discriminatory or preferential.

VII. Other Provisions

A. PUHCA

The Public Utility Holding Company Act (PUHCA) requires registered holding companies to submit to extensive regulation by the Securities and Exchange Commission. PUHCA also generally requires holding companies to operate an "integrated" and contiguous system. As a result, PUHCA encourages concentrations of generation ownership and control in local markets that are inconsistent with competition and discourages asset combinations that could be pro-competitive. PUHCA may also provide a significant disincentive for investment in independent transmission companies that would qualify as RTOs. Under PUHCA, any entity that owns or controls facilities used for the transmission of electric energy - such as an RTO - falls within the definition of a public utility company, and any owner of ten percent or more of such a company would be a holding company and potentially could be required to become a registered holding company. This could serve as a significant disincentive for investments in independent transmission companies that qualify as RTOs.

PUHCA was enacted primarily to undo harms caused by byzantine holding company structures that no longer exist. In the decades since PUHCA was enacted, utility regulation has increased substantially, under the Federal Power Act, federal securities laws

and state laws. PUHCA has outlived its usefulness, and now does more harm than good. PUHCA should be repealed.

B. PURPA

The Public Utility Regulatory Policies Act (PURPA) was enacted in the late-1970s, in the aftermath of that decade's energy crises. The legislation's goal was to remove impediments to the use of cogeneration and renewable-based generation, and promote their use by allowing such generators to require utilities to buy their power at the utilities' avoided costs.

Today, the impediments addressed in PURPA are gone (although other impediments may exist, such as the need for grid expansion). Also, PURPA's "forced sale" requirements are no longer necessary, in light of the availability of open access transmission, to promote the development of competition, and more often serve to distort competitive outcomes. Congress should repeal PURPA, while "grandfathering" existing PURPA contracts.

VIII. Conclusion

We need less, not more, regulation in the generation business. However, we will continue to regulate transmission for the foreseeable future, while encouraging transmission to become a stand-alone business and respond to the market. Congress must focus on removing impediments to the competitive restructuring that is taking place. Outdated laws, such as PUHCA and PURPA, are hindering effective restructuring. The

best way for Congress to help electricity consumers is to promote wholesale competition through the legislative changes described above.